8.0 DISTRIBUTIONS/ACCUMULATED ADJUSTMENTS ACCOUNT

8.1 SCHEDULE M-2

The Schedule M-2 (AAA) is an important area to check when scoping the S corporation return. Reporting trends have identified that corporations may not properly account for taxable vs. nontaxable distributions on this schedule. The Schedule M-2 for California purposes is broken down into three columns, column (a) Accumulated Adjustments Account, column (b) Other Adjustments Account, and column (c) Other Retained Earnings.

During scoping, distributions reported on the Schedule M-2 should be compared with those reported on Schedules K and K-1 to determine, with more confidence, the taxable and nontaxable portions of the distributions.

8.2 ACCUMULATED ADJUSTMENTS ACCOUNT (AAA)

The Accumulated Adjustments Account (AAA, read as triple A) is an account of the S corporation. The S corporation maintains the AAA to track undistributed income that has been taxed during the period its subchapter S election is in effect. (Treasury Regulations (Treas. Reg.) Section 1.1368-2(a))

It is not mandatory to track the AAA if the S corporation does not have subchapter C corporation accumulated earnings and profits (E&P). (Internal Revenue Code (IRC) Section 1368(b)) However, an S corporation should include the AAA in its accounting records in the event that it is needed later if, for example, there is a merger with a corporation that has accumulated E&P. For example, if a corporation with accumulated E&P is acquired through a merger, the S corporation acquires the AAA of the merged corporation as well as its accumulated E&P. The taxability of future distributions is computed using the combined AAA. (IRC Section 381(c)(2) and Treas. Reg. Section 1.1368-2(d)(2))

The auditor should prepare AAA schedules for all S corporations regardless of whether the S corporation has accumulated E&P. Request copies of the S corporation's AAA schedules if not provided on the tax return. Compare these schedules with those computed per audit. Any material discrepancies should be discussed with the taxpayer.

8.3 THE IMPORTANCE OF THE ACCUMULATED ADJUSTMENTS ACCOUNT

The purpose of AAA is to determine the taxability of distributions at the shareholder level.

Distributions up to the amount of AAA can be distributed to the shareholders free of tax at the individual level as long as the distributions do not exceed adjusted stock basis.

If distributions exceed AAA and the S corporation has accumulated E&P, the amount that exceeds adjusted stock basis is treated as taxable dividend distributions to the shareholders up to the extent of any accumulated E&P remaining at year-end. Any portion of the distribution remaining which exceeds accumulated E&P is treated as a capital gain. (IRC Section 1368(c)(2) & (c)(3))

However, if the S corporation does not have any accumulated E&P, then the distributions that exceed AAA are not taxable to the extent of adjusted stock basis (IRC Section 1368(b)(1)). But, to the extent the distributions exceed adjusted stock basis, the excess is treated as a capital gain. (IRC Section 1368(b)(2))

8.4 DO I HAVE A AAA ISSUE?

In general, adjustments are made to both shareholder basis and AAA for items of income, loss, and deductions. (IRC Section 1368(e)(1)(A)) If aggregate adjustments are positive, the shareholder may not be taxed on this amount when actually distributed. In other words, if the distributions are not in excess of the AAA at the time of distribution, it is nontaxable to the shareholder as long as the distributions do not exceed shareholder stock basis.

The following are common situations in which AAA may be an audit issue:

On the S corporation return, AAA would be an audit issue if the S corporation, having accumulated E&P, made distributions during the year that may be in excess of AAA. This information can be found on Schedules K, K-1, and M-2. Schedule M-2 should provide the most information in regard to this issue. If the distributions are greater than the AAA balance before distributions and the S corporation had accumulated E&P, you may have a AAA issue. (Note: Schedule M-2 contains a check box for accumulated E&P. Reporting trends have identified that this box is not consistently checked when accumulated E&P exist. Do not assume the corporation does not have accumulated E&P if this box is not checked.)

On the other hand, if the S corporation does not have any accumulated E&P, then AAA does not become an issue. Instead, the taxability of the distributions made by the S corporation is determined by the adjusted basis of the shareholder's stock (IRC Section 1368(b)).

Under California Revenue and Taxation Code (R&TC) Section 23800, S corporation tax treatment is determined in accordance with Subchapter S of the IRC, except as otherwise provided. Within the R&TC, there are no special provisions for AAA. Therefore, California follows federal law for maintaining AAA. Treas. Reg. Section 1.1368-2(a) states, "On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero." Because California did not recognize S corporations until 1987, there are many instances when federal and California S corporation election dates will be different. As a result, the AAA balance will also be different for federal and California purposes. Auditors should always verify that the AAA they are working with is for California purposes.

California AAA is always different from federal AAA due to federal/state differences such as franchise taxes, depreciation, etc. Compare the federal and California AAA balances to determine whether the corporation made the proper California adjustments.

8.5 ITEMS AFFECTING AAA (IRC SECTION 1368(E), IRC SECTION 1367)

IRC Section 1368(e)(1) defines AAA as follows:

> Except as otherwise provided in this paragraph, the term “accumulated adjustments account” means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under IRC Section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase “(but not below zero)” shall be disregarded in IRC Section 1367(a)(2)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

IRC Section 1367 governs adjustments to shareholder stock basis whereas IRC Section 1368(e)(1)(A) describes adjustments to AAA. Differences between adjustments to shareholder stock basis and AAA are:

- AAA, unlike basis, cannot be increased for tax-exempt income.
- AAA, unlike basis, cannot be decreased for expenses related to tax-exempt income.
- AAA, unlike basis, cannot be decreased for Federal taxes attributable to any taxable year in which the corporation was a C corporation.
- AAA, unlike basis, can go below zero.

8.5.1 Pro-Rata Distributive Share Items That Increase AAA

IRC Section 1368(e)(1)(A); by reference to Section 1367(a)(1)	Also Known As	Specific Income Items
(A) Items of income (excluding tax-exempt income), the separate treatment of which could affect the liability for tax of any shareholder.	Separately stated items	• Rental real estate and other rental income. • Interest and dividend income. • Royalties. • Capital gains. • Other portfolio income. • IRC Section 1231 gain. • Other income.
(B) Non-separately computed income.	Non-separately stated items	• Schedule K-1: Ordinary income from trade or business activities.
(C) The excess of deductions for depletion over the basis of the property subject to depletion.		

Any tax-exempt interest income received by an S corporation will increase AAA (distinguishable from federal). However, any other source of tax-exempt income will not increase AAA. (IRC Section 1368(e)(1)(A)) In *Heller* v. *Franchise Tax Board*, (1994) 21 Cal. App. 4th 1730, the Third Circuit Court of Appeals rejected the department's position that tax-exempt interest income is not included in AAA. The issue addressed whether AAA is based on income that is taxable at the corporate level. The taxpayer argued that it reported Treasury Bill (T-bill) interest as taxable S corporation income and paid taxes accordingly at the corporate level, therefore, AAA should be increased. The department will follow the *Heller* decision and apply it in situations with tax-exempt interest income.

8.5.2 Pro-Rata Distributive Share Items That Decrease AAA

IRC Section 1368(e)(1)(A); by reference Section 1367(a)(2)	Also Known As	Specific Income Items
(A) Distributions by the corporation that were not includible in the income of the shareholder by reason of IRC Section 1368.	Return of capital distributions	
(B) Items of loss or deduction, the separate treatment of which could affect the liability of any shareholder.	Separately stated items	• Rental real estate and other rental losses. • Capital losses. • IRC Section 1231 losses. • Charitable contributions. • Political contributions.

		• Investment interest expenses. • Expense deductions for recovery property. • Deductions related to portfolio income (loss). • Other deductions. *Note*: Credits are not an item of loss or deduction.
(C) Non-separately computed loss.	Non-separately stated items	• Schedule K-1: Ordinary loss from trade or business activities.
(D) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account (Treas. Reg. Section 1.1368-2(a)(3)(i)(C)).	Non-capital, nondeductible expenses	• Nondeductible portion of meals and entertainment expenses. • Wages that are nondeductible because of targeted jobs tax credit. • Research and development (R&D) expenditures that are not deductible because of the R&D credit. • Nondeductible fines and penalties. • Nondeductible life insurance premiums. • Nondeductible franchise tax. *Note*: These include only those items for which no deduction is allowable and do not include items for which a deduction is deferred to a later taxable year.
(E) The amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under IRC Section 613A(c)(11)(B).		

8.6 AAA ORDERING RULES

8.6.1 Ordering Rules Prior to January 1, 1997

Like shareholder basis, AAA is adjusted on the last day of the taxable year. Prior to January 1, 1997, the ordering rules for the adjustments (Treas. Reg. Section 1.1368-2(a)(4)) were as follows:

- Items that increase shareholder basis except tax-exempt income increase AAA.
- Items that decrease shareholder basis except tax-exempt deductions and distributions, decrease AAA.
- Ordinary distributions decrease AAA but not below zero.
- Redemption distributions can increase or decrease AAA.

The only time a AAA balance cannot go below zero is from ordinary distributions (IRC Section 1368(b) or (c)(1), whichever is applicable).

Note 1: The examples used in the S Corporation Manual Section 9.0 Shareholder Basis and S Corporation Manual Section 8.0 Distributions/Accumulated Adjustments Account (AAA) are simplified. They have not been computed on a per day, per share basis as in the Treas. Reg. examples. If you have situations that have multiple stock purchase days, please be aware you need to compute shareholder basis/AAA on a per day, per share basis.

Example A - Prior to 1/1/1997

Alpha Corporation, a federal and California S corporation, reported a beginning AAA balance of $100,000, ordinary income of $100,000 and an IRC Section 1231 Loss of $900,000 for tax year 12/31/1995. Alpha Corporation would compute its AAA for tax year 12/31/1995 as follows:

	AAA
Beginning Balance	$100,000
Ordinary Income	100,000
Subtotal	200,000
IRC Section 1231 Loss	(900,000)
Ending Balance	($700,000)

Unlike shareholder basis, the IRC Section 1231 Loss was allowed to reduce AAA below zero.

Example B - Prior to 1/1/1997

Beta Corporation, a federal and California S corporation, reported a beginning AAA balance of $0, ordinary income of $100,000, an IRC Section 1231 loss of $900,000, and distributions of $500,000 for tax year 12/31/1995. Beta Corporation would compute its AAA for tax year 12/31/1995 as follows:

	AAA
Beginning Balance	$0
Ordinary Income	100,000
Subtotal	100,000
IRC Section 1231 Loss	(900,000)
Subtotal before Distributions	(800,000)
Distributions ($500,000)	0
Ending Balance	($800,000)

Since AAA cannot go below zero from ordinary distributions, no portion of the $500,000 distributions would reduce AAA.

8.6.2 Ordering Rules after August 18, 1998

The ordering rules for the adjustments to AAA changed for taxable years on or after August 18, 1998. The new ordering rules allow the S corporation to disregard any “net negative adjustment” for such taxable year.

A "net negative adjustment" is defined as the excess (if any) of the negative adjustments over the positive adjustments to AAA without considering distributions (IRC Section 1368(e)(1)(C)(ii)). If the S corporation does have a "net negative adjustment", then the ordering rules for the adjustments (Treas. Reg. Section 1.1368-2(a)(5)) are as follows:

- Items that increase shareholder basis except tax-exempt income increase AAA.
- Items that decrease shareholder basis except tax-exempt deductions, "net negative adjustment", and distributions decrease AAA.
- Ordinary distributions decrease AAA but not below zero.
- "Net negative adjustments" decrease AAA.
- Redemption distributions can increase or decrease AAA.

Example C - After 8/18/1998 with Net Negative Adjustment

Gamma Corporation, a federal and California S corporation, reported the following “net negative adjustment” in tax year 12/31/2015:

Ordinary Income	$100,000
IRC Section 1231 Loss	(900,000)
Net Negative Adjustment	($800,000)

Gamma Corporation reported a beginning AAA balance of $200,000 in tax year 12/31/2015. Gamma Corporation would compute its AAA for tax year 12/31/2015 as follows:

	AAA
Beginning Balance	$200,000
Ordinary Income	100,000
IRC Section 1231 Loss ($900,000)	(100,000)
Subtotal	200,000
Net Negative Adjustment ($100,000 – $900,000)	(800,000)
Ending Balance	($600,000)

In this example, the shareholder could have received “tax-free” distributions of $200,000 before taking into consideration the net negative adjustment (subject to shareholder basis limitations). If the shareholder had taken the distributions, the ending AAA balance would be ($800,000).

Example D - After 8/18/1998 with Net Negative Adjustment

Same ''net negative adjustment" as example C. Delta Corporation reported a beginning AAA balance of $0 and distributions of $500,000 in tax year 12/31/2015. Delta Corporation would compute its AAA for tax year 12/31/2015 as follows:

	AAA
Beginning Balance	$0
Ordinary Income	100,000
IRC Section 1231 Loss ($900,000)	(100,000)
Subtotal	0
Distributions ($500,000)	
Net Negative Adjustment ($100,000 – $900,000)	(800,000)
Ending Balance	($800,000)

No portion of the $500,000 distributions would reduce AAA and the taxability would follow the ordering rules as referenced in IRC Section 1368(c)(3) and IRC Section 1368(b).

Example E - After 8/18/1998 with No Net Negative Adjustment

Epsilon Corporation, a federal and California S corporation, reported the following items of income and loss in tax year tax year 12/31/2015:

Ordinary Income	$400,000
IRC Section 1231 Loss	(100,000)
Net Increase	$300,000

Epsilon Corporation reported a beginning AAA balance of $0 and distributions of $500,000 in tax year 12/31/2015. Epsilon Corporation would compute its AAA for tax year 12/31/2015 as follows:

	AAA
Beginning Balance	$0
Ordinary Income	400,000
Subtotal	400,000
IRC Section 1231 Loss ($100,000)	(100,000)
Subtotal before Distributions	$300,000
Distributions ($500,000)	(300,000)
Ending Balance	$0

The portion of the $500,000 distributions from AAA was $300,000. The taxability of the remaining $200,000 distributions would follow the ordering rules as referenced in IRC Section 1368(c)(3) and IRC Section 1368(b). Note that the result is the same for taxable years prior to 1/1/1997 because there is no "net negative adjustment".

8.6.3 Transition Rule

Treas. Reg. Section 1.1368-4 provides a transition rule for the application of the AAA ordering rules during the gap between the effective date of amendments to IRC Section 1368 and the effective date of the final regulations on the ordering rules for the adjustments to AAA. The transition rule allows an S corporation to apply a reasonable method, taking into consideration the statute and legislative history in determining the treatment of its distribution to the shareholder. Thus, during this gap, (January 1, 1997 to August 18, 1998), either of the two ordering rules would be allowed.

Example F - After 01/01/1997 Transition Rule

Zeta Corporation, a federal and California S corporation, reported the following “net negative adjustment” for federal purposes in taxable year ending (TYE) 12/31/1997:

Interest Income	$10,000
Long-Term Capital Gain	100,000
Ordinary Loss from Trade or Business Activities	(500,000)
Charitable Contributions	(10,000)
Net Negative Adjustment	($400,000)

Zeta Corporation reported a beginning federal AAA balance of $150,000 and made distributions totaling $350,000 in TYE 12/31/1997. Zeta Corporation would compute its AAA as follows:

	AAA
Beginning Balance	$150,000
Distributions ($350,000)	(150,000)
Subtotal	0
Net Negative Adjustment	(400,000)
Ending Balance	($400,000)

Zeta Corporation disregarded its “net negative adjustment” and reduced AAA first by the distributions not in excess of AAA $150,000. The AAA was then reduced by the “net negative adjustment” of $400,000 to bring the AAA balance to zero. The taxability of the remaining $200,000 distributions ($350,000 - $150,000) would follow the ordering rules prior to 1/1/1997 as reference in IRC Section 1368(c)(3) and IRC Section 1368(b).

8.7 TAXABILITY OF DISTRIBUTIONS (IRC SECTION 1368(A), (B), (C))

A shareholder may report income from the distributions made by the S corporation. The character of the income to the shareholder (ordinary income versus capital gain) will depend on the applicability of AAA in conjunction with accumulated E&P or shareholder basis. If the S corporation has accumulated E&P, then to the extent distributions are taken from accumulated E&P, the income is ordinary and reported as dividend income on Schedule B. Distributions can be taken from accumulated E&P per the distribution ordering rules listed below or the S corporation may elect with the consent of all affected shareholders, (i.e. shareholders to whom distributions are made by the S corporation during the taxable year) to make distributions directly from accumulated E&P. (IRC Section 1368(e)(3))

However, if the S corporation does not have accumulated E&P, then the taxability of the distribution depends on the amount of shareholder stock basis not AAA (See S Corporation Manual Section 9.0 Shareholder Basis). This is the reason that the statute does not require AAA be maintained if an S corporation does not have accumulated E&P (IRC Section 1368(b)). Further, the character of the income, when the distribution is compared against shareholder stock basis, is capital because the excess of the distribution over stock basis is considered a sale or exchange of property. (IRC Section 1368(b)(2))

Distributions are taxable in this general order:

S corporations without accumulated E&P

- Nontaxable return of capital to extent the distributions do not exceed stock basis.
- Capital gain to the extent the distributions exceed stock basis.

S corporations with accumulated E&P

- Nontaxable to the extent AAA is positive as long as the distributions do not exceed stock basis.

- If stock basis is zero and AAA is still positive, then capital gain to the extent the distributions exceed stock basis.
- If AAA is zero, dividend to the extent of accumulated E&P.

Example G – Distributions by an S corporation without accumulated E&P – General Rule

Ace, Inc. reported a beginning AAA balance of $100,000 and a beginning stock basis balance of $10,000. For the tax year, Ace, Inc. had ordinary income of $50,000, a capital loss of $30,000, and made distributions of $40,000.

	AAA	Stock Basis	Suspended Loss
Beginning Balance	$100,000	$ 10,000	$0
Ordinary Income	50,000	50,000	
Subtotal before Distribution	150,000	60,000	0
Distribution	(40,000)	(40,000)	
Subtotal	110,000	20,000	$0
Capital Loss ($30,000)	(30,000)	(20,000)	(10,000)
Ending Balance	$80,000	$0	($10,000)

- The distributions of $40,000 are from AAA and are not in excess of stock basis therefore are nontaxable.
- The shareholder has a suspended capital loss of $10,000 ($30,000 - $20,000) because the capital loss exceeded his or her stock basis.

The shareholder would report the following on his or her individual return:

- Schedule D – Capital Loss, ($20,000).
- Schedule E – Ordinary Income, $50,000.
- The $40,000 distribution is nontaxable and will not appear on the shareholder's tax return.

Example H - Distributions by an S corporation with accumulated E&P – General Rule

Blue, Inc. reported a beginning AAA balance of $30,000, accumulated E&P of $30,000, a beginning stock basis balance of $25,000 and made distributions totaling $100,000 for the tax year. The income/gain for the distributions would be computed as follows:

	AAA		Accumulated E&P		Stock Basis	
Beginning Balance	$30,000		$30,000		$25,000	
Distributions ($100,000)	(25,000)	(a)	-		(25,000)	(a)
Subtotal	5,000		30,000		0	
Taxable Distributions	(5,000)	(b)	(30,000)	(c)	0	(d)
Ending Balance	$0		$0		$0	

(a) Nontaxable to the extent that AAA and stock basis are not exceeded, $25,000.
(b) Capital gain to the extent AAA is not exceeded, but stock basis is exceeded, $5,000.
(c) Dividend to the extent of accumulated E&P, $30,000.
(d) Nontaxable return of capital to extent of remaining stock basis, $0.
Remaining balance of the distributions is a capital gain of $40,000 (100,000 – 25,000 - 5,000 - 30,000).

The shareholder would report the following on his or her individual tax return:

- Schedule B - Dividend Income, $30,000.
- Schedule D - Capital Gain, $45,000 (5,000 + 40,000).
- $25,000 of the distributions is nontaxable and will not appear on the shareholder's tax return.

Note: In most instances, stock basis is higher than AAA.

Treas. Reg. Section 1.1368-1(b) states that a "distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder." Therefore, AAA is adjusted in the year the S corporation makes the distribution, regardless of when the distribution was declared by the S corporation or the shareholder that received the distribution. Furthermore, in general, distributions made during the taxable year are deemed to have been made at the end of the tax year because adjustments to distributions cannot be made until after the income adjustments for shareholder basis, which occurs at the end of the tax year (IRC Section 1367).

Example I - Distributions by an S corporation with accumulated E&P and no "Net Negative Adjustment" after 8/18/1997

Candy, Inc. reported a beginning AAA balance of $200,000, accumulated E&P of $100,000, and a beginning stock basis balance of $200,000. For the tax year, Candy, Inc. had ordinary income of $200,000, an IRC Section 1231 Loss of $150,000, and made distributions of $150,000. Further, Candy, Inc. did not make an IRC Section 1368(e)(3) election to distribute accumulated E&P first.

	AAA	**Accumulated E&P**	**Stock Basis**
Beginning Balance	$200,000	$100,000	$200,000
Ordinary Income	200,000	0	200,000
Subtotal	400,000	100,000	400,000
Distributions	0	0	(150,000)
IRC Section 1231 Loss	(150,000)	0	(150,000)
Subtotal before Distributions	250,000	100,000	100,000
Distributions	(150,000)	0	0
Ending Balance	$100,000	$100,000	$100,000

- The $150,000 distributions are from AAA and are not in excess of stock basis and therefore are nontaxable.
- No part of the distributions is from accumulated E&P.
- Candy, Inc. could have made additional “tax free” distributions from AAA of $100,000 without getting into accumulated E&P.

The shareholder would report the following on his or her individual tax return:

- Schedule D – IRC Section 1231 Loss, ($150,000).
- Schedule E – Ordinary Income, $200,000.
- The distributions of $150,000 is nontaxable and will not appear on the shareholder's tax return.

Note: The $150,000 distribution is reported in a different order for AAA and shareholder stock basis due to the differences in the ordering rules for AAA and shareholder basis (Treas. Reg. Section 1.1367-1)). Refer to S Corporation Manual Section 9.0 Shareholder Basis for a detailed discussion regarding the ordering rules for shareholder basis.

Example J - Distributions by an S corporation with accumulated E&P and a "Net Negative Adjustment" after 8/18/1997 - Treas. Reg. Section 1.1368-1(e)

Daisy, Inc. reported a beginning AAA balance of $200,000, accumulated E&P of $100,000 and a beginning stock basis balance of $200,000. For the tax year, Daisy, Inc. had ordinary income of $200,000, an IRC Section 1231 Loss of $350,000 and made distributions totaling $250,000. Further, Daisy, Inc. did not make an IRC Section 1368(e)(3) election to distribute accumulated E&P first.

	AAA	Accumulated E&P	Stock Basis
Beginning Balance	$200,000	$100,000	$200,000
Ordinary Income	200,000	0	200,000
Subtotal	400,000	100,000	400,000
IRC Section 1231 Loss ($350,000)	(200,000)	0	0
Subtotal before Distributions	200,000	100,000	400,000
Distributions ($250,000)	(200,000)	(50,000)	(200,000)
Subtotal	0	50,000	200,000
Net Negative Adjustment ($200,000-$350,000)	(150,000)	0	0
IRC Section 1231 Loss	0	0	(200,000)
Ending Balance	($150,000)	$50,000	$0

- The shareholder has nontaxable distributions to the extent that AAA and stock basis are not exceeded, $200,000.
- The shareholder has dividend income to the extent of accumulated E&P, $50,000.
- The shareholder has a suspended IRC Section 1231 loss of $150,000 ($350,000 - $200,000).

The shareholder would report the following on his or her individual return:

- Schedule B – Dividend Income, $50,000.
- Schedule D – IRC Section 1231 Loss, ($200,000).
- Schedule E – Ordinary Income, $200,000.
- $200,000 of the distributions is nontaxable and will not appear on the shareholder's tax return.

8.8 DISTRIBUTIONS THAT BYPASS AAA (IRC SECTION 1368(E)(3), R&TC SECTION 23811(E))

The most favorable distribution to an S corporation shareholder is usually a nontaxable distribution from AAA. However, there are certain situations when taxable distributions from accumulated E&P are more desirable.

- The corporation is vulnerable to involuntary termination of its S election due to excess passive investment income (IRC Section 1362(d)(3)). The threat of termination applies only if the S corporation has excess passive investment income at the end of the third consecutive year. (See S Corporation Manual Section 7.0 Excess Net Passive Income Tax).
- The corporation is subject to excess net passive income tax (IRC Section 1375, R&TC Section 23811). The tax applies only if the corporation has accumulated E&P.
- The shareholder has losses on his or her individual return that can be utilized if those losses are offset by income.
- The shareholder has investment interest expenses that cannot be deducted unless the shareholder reports investment income, etc.

Thus, the S corporation with the consent of all shareholders may make an IRC Section 1368(e)(3) election to distribute accumulated E&P before AAA.

IRC Section 1368(e)(3) provides that a corporation may make an election to distribute accumulated E&P before AAA on the return. The election has to be made and attached to the return (refer to the Federal Form 1120S or California Form 100S Instructions). (Treas. Reg. Section 1.1368-1(f)) There are three methods in which to make the election.

- Election to distribute accumulated E&P first.

  The corporation can make an actual distribution from accumulated E&P first and issue a 1099-DIV to each shareholder. The shareholders report the taxable dividends on their individual returns.

- Election to make a deemed dividend distribution.

  A deemed dividend distribution is treated as if it were a pro-rata distribution of money to the shareholders, which is received by the shareholders and immediately contributed back to the corporation all on the last day of the tax year.

- Election to forgo Previously Taxed Income (PTI).

  This is a federal provision for tax years prior to the Subchapter S Reform Act of 1982, therefore, the election to forgo PTI does not apply for California purposes.

Any election stated above is irrevocable and applies only for the tax year for which the election is made. The S corporation must attach the election statement to the original or amended return and all affected shareholders must consent to the election.

8.9 OTHER ADJUSTMENTS ACCOUNT AND OTHER RETAINED EARNINGS

The Other Adjustment Account (OAA) is used as a reconciliation account. The Federal Form 1120S, Schedule M-2, Column (b) and the related instructions provides the only reference to the OAA. It is not mentioned in Subchapter S or the regulations promulgated under Subchapter S. The OAA is used to determine basis where nontaxable events have occurred. Tax-exempt income and expenses are the most common items contained in the OAA. These items increase basis, but not AAA, with the exception of tax-exempt interest income pursuant to the *Heller* vs. *Franchise Tax Board* decision.

The Other Retained Earnings are the S corporation's appropriated and unappropriated retained earnings accumulated in the prior C corporation years. The beginning balance for an S corporation's first tax return will be the sum of the ending balances of appropriated and unappropriated retained earnings for the previous C corporation tax years.

8.10 MISCELLANEOUS ITEMS

The AAA is a corporate-level account. If a shareholder disposes of his shares to another shareholder, the succeeding shareholder can receive a distribution out of the prior AAA balance, even though the succeeding shareholder may not have reported any distributive share income that generated the prior AAA balance.

This is different from shareholder basis whereby shareholder basis attaches to the shareholder. When a shareholder disposes of his shares, the succeeding shareholder cannot carry over the prior shareholder’s basis. Instead, the succeeding shareholder's initial basis is his cost of acquiring the stock.

Cash distributions during the post-termination transition period are nontaxable to the extent of the ending balance of AAA (but limited to the shareholder's stock basis). The post-termination transition period generally begins on the day after the corporation's last day of S status and ends on the later of (1) one year after such last day or (2) the due date (including extensions) of that year's tax return. (IRC Section 1371(e)(1))

The regulations under IRC Section 1368 also provide a new election to split the tax year in two in case of a "substantial stock disposition." If a shareholder disposes of 20% or more of an S corporation's issued stock in one or more transactions within any 30-day period during the corporation's tax year, the corporation can elect to treat the tax year as if it consists of separate years (for purposes of allocating income and loss, adjusting AAA, shareholder basis, and accumulated E&P, and determining the taxability of distributions). (Treas. Reg. Section1.1368-1(g)(1))

If an S corporation is not paying a "reasonable" salary to a shareholder-employee, distributions to that shareholder-employee may be recharacterized as wages subject to payroll taxes. (*David E. Watson, P.C. v. United States* (2011) 668 F.3d 1008, cert. den. 568 U.S. 888 and also held in Revenue Ruling 74-44, 1974-1 C.B. 287)

Disproportionate distributions, constructively or actually made, may result in a deemed second class of S corporation stock if the distributions are designed to defeat the one class of stock rule. (Treas. Reg. Section 1.1361-1(l)(2)(i))

8.11 EXHIBIT

Exhibit 8.11.1

- A checklist of the items affecting shareholder stock basis and the AAA.
- Adjustments to shareholder stock basis, AAA, and accumulated E&P during the post-termination transition period.

EXHIBIT 8.11.1

ITEMS AFFECTING STOCK BASIS AND AAA

The following is a checklist of items that affect stock basis and the accumulated adjustments account (AAA).

Increased by	**Stock Basis**	**AAA**
Nonseparately stated items of income	Yes	Yes
Separately stated items of income	Yes	Yes
Tax-exempt income	Yes	No
COD income – On or before 12/31/02 (*Gitlitz* v. *Comm.*, 2001 531 US 206)	Yes	No
COD income – After 12/31/02	No	No
The excess of the deduction for depletion over the basis in the property subject to depletion, unless the property is oil & gas property.	Yes	Yes
Capital contributions	Yes	No

Decreased by	**Stock Basis**	**AAA**
Nonseparately stated items of loss	Yes	Yes
Separately stated items of loss or deduction	Yes	Yes
Deductions relating to tax-exempt income	Yes	No
Corporate expenses that are neither deductible nor capitalizable	Yes	Yes
The amount of the shareholder's deduction for depletion with respect to oil and gas property to the extent such deduction does not exceed the shareholder's proportionate share of the corporation's basis in the property.	Yes	Yes
Distributions	Yes [1]	Yes [2]

1 – Distributions cannot decrease basis below zero. The excess distributions are then taxable under IRC Section 1368.

2 – Distributions cannot decrease AAA below zero. If the corporation has accumulated E&P, the excess will be treated as dividend income.

Negative balance	**Stock Basis**	**AAA**
Balance can go below zero (negative)	No	Yes

ADJUSTMENTS TO BASIS, AAA, AND AE&P DURING THE POST-TERMINATION TRANSITION PERIOD

Shareholder basis and S corporation level accounts are adjusted during the post-termination transition period (PTTP), and are accounted for at the end of the PTTP, in the following manner:

Item	IS ADJUSTED DURING THE PTTP AS FOLLOWS:	And at the Conclusion of the PTTP is:
Stock Basis	• Is increased by the amount of cash or property contributed to the corporation during the PTTP. • Is decreased by losses suspended as of the last day of S status due to lack of basis that are passed through to the shareholders during the PTTP. • Is decreased by losses suspended as of the last day of S status due to lack of basis that are passed through to the shareholders during the PTTP. • Is decreased by non-dividend distributions during the PTTP. • Is NOT increased by income earned or realized during the PTTP. • Is NOT decreased by losses or deduction realized during the PTTP.	• Carried over and becomes the shareholder's basis in the C corporation stock.
Debt Basis	• Is NOT increased by income earned or realized during the PTTP. • Is NOT decreased by losses or deductions realized during the debt owned by the PTTP.	• Carried over and becomes the shareholder's basis in the C corporation.
Accumulated Adjustments Account (AAA)	• Cannot increase during the PTTP. • Is decreased by non-dividend distributions during the PTTP.	• Loses its identity as AAA and therefore loses its tax-free attributes. Is carried over as part of the C corporation's retained earnings.

Accumulated Earnings & Profits (E&P)	• Is increased by income earned or realized during the PTTP. • Is decreased by losses and deductions realized during the PTTP. • Is decreased by dividend distributions during the PTTP.	• Carried over and becomes part of the C corporation's accumulated E&P.

Revised Date: December 2018